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384589—56

In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 846

CITY CHEVROLET COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet 1a–19a) are not reported. The opinion of the Court of Appeals (Pet. 20a–21a) is reported at 228 F. 2d 894.

JURISDICTION

The judgment of the Court of Appeals was entered on January 11, 1956. The petition for a writ of certiorari was filed on April 10, 1956. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254 (1).

QUESTION PRESENTED

Whether the amount taxpayer-corporation claimed as a deduction for salaries paid to its two-officer stockholders exceeded a reasonable allowance for personal services actually rendered.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) [As amended by Sec. 121 (a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—
>
> (1) *Trade or business expenses.*—
>
> (A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *
>
> * * * * * *
>
> (26 U. S. C. 1952 ed., Sec. 23 (a).)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

> SEC. 29.23 (a)–6. *Compensation for Personal Services.*—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation

payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (*a*) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (*b*) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility.

While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

STATEMENT

The Tax Court's findings (Pet. 2a–17a), which the Court of Appeals held to be fully supported

by the evidence (Pet. 20a–21a), may be summarized briefly as follows:

In 1935, General Motors Corporation, investing $27,000, organized the taxpayer and installed P. L. Abernethy, who invested $3,000, as its president. General Motors retained control but provided for Abernethy's gradual assumption of ownership through the purchase of voting stock out of a bonus to be paid to him. The bonus was to be 50 percent of the net profit in excess of 15% of the average month-end invested capital. Taxpayer obtained a franchise from the Chevrolet Division of General Motors and Abernethy, who had extensive experience in the automobile business, was elected a director and president. (Pet. 2a–6a.)

On March 19, 1941, Abernethy, having completed his purchase of non-voting stock and its transfer to voting stock, took control of taxpayer and transferred one-half of the stock to E. R. McHenry and one share to his wife Violet M. Abernethy. At a meeting of the board of directors on that day McHenry and Violet Abernethy were elected to the board and McHenry was elected vice-president. At the same meeting a new bonus agreement was authorized and adopted which provided for the payment to each Abernethy and to McHenry of a bonus of 25 percent of the net profits. (Pet. 6a–7a.) Later in 1944, after gifts of stock to the wives of Abernethy and

McHenry, the stock ownership was as follows (Pet. 8a):

Name	*No. Class B Shares*
P. L. Abernethy	145
E. R. McHenry	140
Violet Abernethy	130
Lettie S. McHenry	135

McHenry, who also had considerable experience in the automobile business, first joined taxpayer in 1935 as new car sales manager. He left in June of 1937, returned in December of that year, and left again in May of 1938. Abernethy rehired McHenry in 1939 as vice-president and agreed to pay him 50 percent of his bonus and to allow him to buy one-half of the stock as Abernethy acquired it from General Motors. Abernethy held the stock in trust for McHenry until 1941. (Pet. 8a–10a.)

Beginning in 1939, McHenry was in charge of sales and personnel and consulted with Abernethy on all operations. Prior to that time, Abernethy had customarily spent 12 to 18 hours a day renovating and rebuilding the agency and revamping the whole organization. After 1939, Abernethy and McHenry developed programs for each department of the business. Abernethy looked after the financial aspects of the business and maintained factory controls. (Pet. 8a, 10a.)

During 1940 and 1941, there was heavy production of automobiles. In 1940, taxpayer opened a truck service department. In the latter part of 1941 there was a Government freeze on new pro-

duction. Near the end of this year, taxpayer and other dealers had heavy inventories of new cars. Abernethy and McHenry felt that the best way to survive the situation was to have as many new models as possible and they took every unit the factory would deliver. They also bought new cars from other dealers and by March of 1942 taxpayer had 242 models in various storage facilities. (Pet. 10a–11a.)

At the beginning of the post-war period in 1946, under new and improved training procedures, a new sales force was organized. However, there was no difficulty in selling all cars that could be obtained in that year. (Pet. 12a.)

Taxpayer paid dividends in eight of its first eleven years of existence but paid no dividends in 1946, 1947, and 1948. (Pet. 16a.)

Taxpayer paid Abernethy and McHenry salaries of $12,000 each in 1946, plus bonuses of $30,881.69, or a total of $85,763.38. (Pet. 15a.) The Commissioner disallowed the bonuses. (Pet. 17a–18a.)

On the evidence before it, the Tax Court found that $50,000 (*i. e.*, $25,000 for each officer) was reasonable compensation for the services of Abernethy and McHenry for the year 1946 (Pet. 17a). The Court of Appeals affirmed this finding.

ARGUMENT

Section 23 (a) (1) (A) of the Internal Revenue Code of 1939, *supra*, p. 2, allows a tax-

payer to deduct from income ordinary and necessary expenses of conducting a business, including "a reasonable allowance for salaries or other compensation for personal services actually rendered * * *." Section 29.23(a)-6 of Treasury Regulations 111, *supra*, pp. 2–3, states the test of deductibility to be whether the compensation payments are reasonable and "in fact payments purely for services."

The single issue in this case concerns the amount which taxpayer corporation should be allowed to deduct as reasonable compensation for the services of its two officer-stockholders. Challenging the concurrent findings of the Tax Court and the Court of Appeals, taxpayer contends (1) that the courts below ignored relevant evidence (Pet. 9), and (2) that the Commissioner failed to establish the unreasonableness of the amount claimed as salary deductions (Pet. 17). These contentions are insubstantial and the asserted conflicts do not exist.

1. Taxpayer's contention (Pet. 8–15) that in reaching their conclusion as to reasonable compensation the courts below ignored the bonus agreement is refuted by the record. The Tax Court gave full recognition to the agreement when it held that the total compensation paid in 1945, which included $4,527.67 as a bonus to each officer, was reasonable. It was only when the amount paid under the bonus formula reached an extravagant level in 1946 that the court found

it could no longer accept the "bonus" label. The amount finally determined to be reasonable for 1946, the year in issue, included $13,000 as a bonus in addition to a salary allowance for each officer. (Pet. 15a, 19a.)

The Commissioner has recognized bonus agreements in his Regulations as approved by the Secretary of the Treasury (Sec. 29.23(a)-6(1), *supra,* p. 3), but has prescribed that "[i]n any event the allowance for compensation paid may not exceed what is reasonable under all the circumstances."

Taxpayer argues (Pet. 9) that the Court of Appeals for the Fifth Circuit has followed an erroneous view with regard to bonus agreements as shown by its decision in the case of *University Chevrolet Co.* v. *Commissioner,* 199 F. 2d 629. This is not borne out by a reading of that opinion. Judge Holmes speaking for the court observed (p. 630):

> Bonuses to employees will constitute allowable deductions * * * provided such payments, when added to stipulated salaries, do not exceed a reasonable compensation for the services rendered.

Contrary to taxpayer's assertion (Pet. 11), there is no conflict as between the position taken in the instant case or in the *University Chevrolet* case and the position of the Sixth Circuit in *Mayson Mfg.* v. *Commisioner,* 178 F. 2d 115. There, the court allowed the salary paid under the

bonus plan because it was not unreasonable. The Sixth Circuit was careful to point out that the question was one of fact and that several criteria should be considered in determining reasonableness.

Taxpayer's real contention is that bonus agreements are completely controlling and leave no room for consideration of the reasonableness of the compensation. This contention, however, does not square with the statute which permits deductions only of "reasonable allowance for salaries or other compensation for personal services actually rendered." (Sec. 23 (a) (1) (A).)

2. Taxpayer's contention (Pet. 17) that neither court below required the Commissioner to justify his determination overlooks the fact that the taxpayer seeking a deduction from income has the burden of establishing not only its right to the deduction, but also the amount of such deduction. *New Colonial Co.* v. *Helvering,* 292 U. S. 435.

Taxpayer asserts a conflict between the instant case and decisions of the First, Fifth, Sixth, and Tenth Circuits as to the effect of the Commissioner's failure to offer testimony on the reasonableness of the compensation in issue. (Pet. 15–17.) An examination of the decisions (Pet. 15, 16), however, reveals that each Court of Appeals recognized that the question presented was one of fact and that whether the compensation paid was reasonable depended upon the

particular circumstances shown.[1] In the instant case, the Tax Court had before it stipulations of fact and numerous exhibits. And it heard, both on direct and cross examination, the testimony of the six witnesses called by taxpayer. Obviously, it could consider the facts as to which they testified as well as their opinions or ultimate conclusions on the subject of reasonableness of compensation. As the detailed findings and the opinion of the Tax Court show (Pet. 1a–19a), the court considered and evaluated the prevailing economic conditions, the size and the complexities of the business, the salaries paid to persons in comparable positions, and the nature and extent of the services rendered. These are the criteria invariably applied in determining the reasonableness of compensation under any given set of facts. On the basis of its consideration of the record, the court allowed a deduction substantially in excess of the amount allowed by the Commissioner (for the year 1946, $50,000 as compared to $24,000). The court was scarcely obliged to accept, without any qualification, the ultimate conclusions reached by taxpayer's witnesses.

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[1] This proposition is, of course, well settled. See, *e. g.*, *Long Island Drug Co.* v. *Commissioner*, 111 F. 2d 593 (C. A. 2d), certiorari denied, 311 U. S. 680; *San Marco Shop* v. *Commissioner*, 223 F. 2d 702 (C. A. 5th); *Al Haft Sport Enterprises* v. *Commissioner*, 189 F. 2d 384 (C. A. 6th).

CONCLUSION

The issue determined below was factual in nature and there is no conflict of decision as to whether the appropriate criteria were applied. There is no occasion for further review of the concurrent findings. Accordingly, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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